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How Close to Bankruptcy Are You?

Helene M. A. Ramanauskas

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Business failures—reaching from mere temporary insolvencies to outright bankruptcies—have been with us since there exists business. Since they represent even in periods of prosperity a social and economic problem of great significance and of far-reaching impact,[1] crucial questions such as "What are the causes of these business casualties?" and "Could it happen to me?" seem therefore quite in order.

When trying to answer these questions, one becomes aware that there are great similarities between the death of a human being and that of a business. Both generally do not occur overnight, but are preceded by a serious disease or a combination of several diseases, which, if diagnosed in their early stages, might have been properly remedied. Both an individual and a business might possess inherited weaknesses that predispose them to certain attacks and maladies. Just as it is advisable for an individual to visit his physician regularly for a check-up, a business firm should also undergo periodic examinations, through analysis and interpretation of its financial statements, in order to assure discovery of ailments at a stage where they are still curable.

The methods of diagnosis used by physicians and business analysts are also quite similar since they are, in both instances, based on a complete study of individual signs and symptoms which then serve as the basis not only for diagnosing the disease and observing and forecasting its future course, but also for prescribing the proper remedy to cure it.

The author shall attempt to picture first the several transitional stages of business failures, and shall then analyze the major underlying causes and the symptoms indicating their presence. The discussion of the existing methods for diagnosis and suggestions as to suitable remedies for various sorts of business ailments will round up the elaborations and leave it up to the individual reader to determine how close to bankruptcy his own or his client's business is.

[1] Dun & Bradstreet, Inc. "The Failure Record Through 1964."

Transitional Stages of Business Failures

Bankruptcy of a business does not happen suddenly and unexpectedly. An ailing business passes through several transitional stages before the final tragedy happens. Such enterprise is comparable with an individual suffering at the start from a minor ailment, such as a common cold, which if not remedied, in due time could develop into a serious disease like pneumonia which might result in death.

The first stage might be called the period of incubation. During this period, one or even a number of unfavorable conditions are quietly developing without being recognizable immediately by outsiders or even by management.

The first acute warning of trouble comes in the second stage when the enterprise for the first time is unable to meet its current obligations and is in urgent need of cash although it might have a quite comfortable excess of physical assets over the liabilities and a satisfactory earning record. The problem at this point is only that the assets are not sufficiently liquid, and that the necessary working capital is tied up in receivables, inventories and temporary investments. As long as such a firm is able to borrow sufficient funds temporarily or can secure an extension of its debts' maturities, a financial rehabilitation at this stage is still comparatively easily possible.

The third stage termed financial insolvency occurs when a business is unable to procure through customary channels the funds required to meet its maturing and over-due obligations. Management will have to resort to more drastic measures to put the concern back on its feet. A business or financial specialist may be called in to take charge of the firm, or a creditors' committee may be appointed to supervise or even to take over the management of the ailing business. Management might resort to new financing techniques, such as the sale of common and/or preferred stock, bonds or notes, to procure the necessary funds. If at the same time operational and financial policies are also completely analyzed, overhauled and modified, and the actual causes for the unfavorable conditions are detected and remedied, there still exists a good possibility for survival and for future growth and prosperity.

If all these efforts prove unsuccessful, as may be the case when the fundamental causes of failure have not been detected and eliminated, the fourth step, known as total insolvency, will be reached fairly soon. At this critical point, where liabilities already exceed the physical assets, the business can no longer avoid the public confession of failure, and management's desperate efforts to secure further funds by more financing generally prove unsuccessful.

The total insolvency becomes a so-called confirmed one after legal steps are taken to protect the rights of creditors by filing a petition for receivership in a Federal District Court. Such petition may be filed voluntarily by the debtor, or the proceedings may be initiated by a sufficient number of his creditors.

After a receiver is appointed by the court to administer the affairs of the failing business, final efforts will be made to ascertain the real causes of failure and to reorganize the enterprise. If a feasible reorganization plan can be developed, attempts will be made to secure the necessary funds to finance the enterprise's present and immediate future operations, an extension of debt maturities will be negotiated with the creditors, and a competent management will be appointed to guide the firm in regaining a solvent and sound financial condition.

If the enterprise's financial and operational difficulties are too severe to overcome even by drastic reorganization measures, a trustee succeeds the receiver, and he proceeds to liquidate the business as quickly as possible. The firm is now in the final stage of adjudicated bankruptcy.

Major Symptoms and Underlying Causes of Business Failures

When studying the statistics of business casualties, it becomes obvious that not only neophyte enterprises with little knowledge and low competence are foundering, but also long-established businesses. What are the difficulties that obviously prove insoluble to both young and old managements of various types of businesses?

Since knowledge of those difficulties suggests the possibility of preventing future failures and is also the prerequisite for applying suitable remedies before it is too late, several studies have been made to establish the specific causes.

Dun & Bradstreet, Inc. analyzes annually all bankruptcy cases and publishes their apparent causes as a service to the business community. The 1964 study disclosed that only 8.1% of the total failures resulted from disaster, strikes, employees' fraud, and from neglect caused by poor health and other difficulties. The bulk of the failures, namely 91.9%, stems from managerial incompetence, evidenced by inability to avoid conditions resulting in inventory and receivables difficulties, excessive fixed assets, too high operating expenses, inadequate sales and competitive weaknesses of various types.

The most extensive study to establish causes of business failures was made by Dr. Paul J. Fitzpatrick in 1936.[2] He classifies the destructive forces that persistently confront enterprises and endanger their survival into internal and external factors.

External factors, such as disaster, unfavorable legislation, changes in style and consumer habits, the introduction of substitutes and the effects of business cycles, are generally beyond the control of management, but prudent and capable management can safeguard against them to a considerable degree through insurance, proper planning and flexibility.

As the real danger, Fitzpatrick considers the *internal factors,* such as over-investment in fixed assets, inventories and receivables; insufficient working capital; a weak cash position; an unbalanced capital structure; inadequate and declining sales; insufficient net earnings; excessive expenditures; and various others. They, he feels, are the fundamental causes of business failures, and are usually the outward sign of various degrees of managerial inability.

Because of their drastic impact on the well-being of an enterprise and their frequent far-reaching consequence, the major types of internal causes of business failures and the most important symptoms indicating their presence are discussed in more detail.

Insufficient Working Capital

Working capital, the excess of current assets over current liabilities, available to finance current operations, is the life blood of a business and frequently the principal means of earning profits. Lack of sufficient working capital may

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[2] Paul J. Fitzpatrick, Ph.D., "The Problem of Business Failures," The Dolphin Press, Philadelphia, Pa.

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ADEQUATE ACCOUNTING RECORDS

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Would it not be possible for AWSCPA and ASWA groups to try to help fill in the gap in the education of the many who will go into some small business in the future by sponsoring a series of educational television programs or public conferences? These should not be courses in the mechanics of bookkeeping, but rather, should be developed around the basic need for the fundamentals of sound accounting methods in any business enterprise, and the uses to which accounting records can be put as an aid to management. A project such as this would require a great deal of time and careful planning, but it need not necessarily cost a great deal of money. Assistance might be obtained from university continuing education departments, and from the Small Business Administration which has a big stake in the solvency of the thousands of small businesses throughout the country to whom it has made loans. We have the brains and the woman power needed to carry it out. Even if the program reached only a few small entrepeneurs it should have value to the business world and to women accountants themselves.

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seriously impair business activities, just as a condition of anemia may have serious consequences for a human being.

In most cases, lack of working capital is a symptom of an advanced stage of business failure and not the cause of it; it is the result of poor managerial policies, unusual and unexpected losses, excessive operating expenses, too high interest and other fixed charges.

If the working capital has diminished to such a degree that the current liabilities exceed the current assets, a floating debt or a working capital deficit exists, which calls for an immediate diagnosis of the underlying causes and drastic remedies, if the enterprise is to be saved.

Weak Cash Position

Another condition, which is a symptom rather than a cause of business failure is a weak cash position. It may exist even though the company has seemingly sufficient working capital, but the portion of cash compared to other current assets is insufficient.

The actual amount of cash needed to keep a business on a healthy basis depends on factors like the size and character of the business, the phase of the business and operating cycle, the season of the year, the working capital turnover and others. In general, however, a cash fund equal from one to three months of operating expense (excluding depreciation and other non-cash expenditures) is considered adequate.

Over-Investment in Fixed Assets

The decision in regard to the amount of investment in fixed assets required and justifiable in the light of current and expected customer demand, is one of the most vital, key problems of management.

Besides the fact that over-investment in fixed assets ties up capital for a comparatively long period of time and deprives the enterprise from using it for advantageous current business opportunities and for the payment of current obligations, it may endanger permanently the over-all profitability of the business. The cost incurred in maintaining excess capacity may have to be absorbed by a smaller production or sales volume than intended, resulting in higher per unit cost and a continued drainage on profits.

Since the capital used to finance fixed assets will be tied up for an extended period, it is axiomatic to finance them by long-term obligations, such as bonds and mortgages, and through re-investment of earnings. To do otherwise is neither sound economics nor good business judgment and will result in serious financial difficulties.

Over-Investment in Inventories

This decisive factor in business failures may be due either to efforts to provide against inadequate supplies of raw material or merchandise, or to the desire to earn additional profits in periods of rising prices or general prosperity. It may result, however, also from lack of control, sudden style changes, partial obsolescence or other similar factors.

Excessive investment in inventories will not only impair an enterprise's working capital position by tying up a disproportionate amount of money, but it might also weaken its earning potential in various ways. The inventory carrying cost of the excess inventory on hand will increase overhead expenses unnecessarily and eat up profits. The disproportionate increase of inventories relative to sales will result in a slow-down of their turn-over and in adverse effects upon the rate of return. Losses may also be suffered when the firm attempts to liquidate such excess inventories because of possible decline in demand and prices, or because of the urgency to obtain cash or rights to cash and the consequent necessity of selling below the customary selling price or even below cost.

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year carryover provisions, a word of caution is in order.

Many national charities have branches throughout the country that are operated on an autonomous basis. For this reason each local unit must obtain an individual ruling from the Treasury Department as to their exempt status. While such rulings have been obtained at the outset of their organization, in many instances these charities have not applied for a redetermination concerning 30% status under the 1964 Revenue Act. Prior to making gifts, additional rulings should be obtained, in view of the possible loss of tax benefits if it is determined later that the recipient of the gift does not qualify. The question that poses the problem is whether a particular charity is a "publicly supported" organization. In view of somewhat ambiguous terminology present in the temporary regulations and the recently issued Revenue Ruling 66-100, certain organizations may find that they do not meet the definition. Public support does not include income from the performance of the purposes for which the charity was organized. In many instances there has been an outgrowth of services rendered that are a natural *complement* to the primary functions of the organization. The Treasury Department might, however, take the position that these services are in fact within the scope of the charitable purpose responsible for the organization, and did not constitute public support.

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Over-Investment in Accounts Receivables

Excess indebtedness owed to an enterprise by its customers as the result of sales also impairs working capital and may be a contributing cause to business failures. It occurs when a business has too much working capital, frequently even interest-free, tied up in its receivables because of too-extended credit terms, carelessness in credit granting and poor collection methods.

Unbalanced Capital Structure

Another vital prerequisite for long-range financial soundness of an enterprise is a well-balanced capital structure. The enterprise should maintain at all times a healthy relationship between debt capital and equity capital.

Equity capital represents a permanent investment in the business, while debt capital is only temporarily invested. Equity capital is interest-free, and much less risky to the company because shareholders receive dividends only at the discretion of the directors. Debt capital, on the contrary, is extremely risky since bondholders and other creditors when not paid promptly can take legal actions to obtain payment and even force the company into bankruptcy. An excessive amount of debt capital also burdens the enterprise with heavy fixed interest charges which must be paid regardless of the financial and earning condition.

The greater the proportion of equity capital, the less worry the company will have in meeting fixed obligations. The more funds are obtained through debt captial, the more the company can trade on the equity, by using funds obtained at relatively low interest rates in its operations in the hope of earning a higher over-all rate of return.

What constitutes a well-balanced capital structure cannot be determined for businesses in general. However, there exists a financial axiom that the owners should have more equity in the business than the creditors. The lower the percentage of equity capital to total capital gets, the greater the risk of losing control becomes.

Temporary excessive funded debts are justifiable if used for expansion of fixed assets so long as they will result in increased production, sales and earnings. Excessive short-term debts are always undesirable since they not only impair the company's working capital position but also result in a serious drain on cash resources when the obligations mature.

Inadequate or Declining Sales and Profits

It is generally agreed that net sales constitute the backbone of business and that net profits represent its soul, for without net profits all business is economically doomed to death.

Profits in turn depend upon several interrelated factors, such as the volume of business done, the various costs of conducting it, the prices at which the products are sold and the proportions in which the different products or product lines are sold. A change in any one of these factors generally has an effect upon another and an effect upon profit.

Sound decisions in regard to any one of these factors depend upon the knowledge of how costs vary with changes in output, and how sales volume responds to changes in price. All too often businesses fail because of management's lack of sufficient knowledge of this basic cost-volume-profit relationship.

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Uniform CPA Examination Grading Staff

Several positions are open on the Advisory Grading Staff for CPAs to grade the Uniform CPA Examination at the Institute headquarters in New York City. The approximate dates for grading the November 1966 CPA Examination are November 25 through January 5.

Graders must be able to grade at least three full days a week for the entire grading period (grading may be done on Saturdays), and they are expected to make the semi-annual grading engagement a part of their practices. Graders are paid on a per diem basis.

Interested CPAs should write William C. Bruschi, Director of Examinations, American Institute of Certified Public Accountants, 666 Fifth Avenue, New York, New York 10019. All applicants under consideration will be personally interviewed.

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A management without concise knowledge as to the pattern with which their individual costs vary with volume of output cannot determine with any degree of reliability at what sales volume their operations under a given capacity would break even, yield a certain amount of profit, or would produce the maximum profit possible. Their ignorance also renders them impotent in systematic attempts to control and to reduce costs and in obtaining a satisfactory net profit. Such management is worse than gamblers who at least study the laws of chance when making decisions.

Another prerequisite for successful operations is management's ability to attain and to maintain sufficient sales. This requires a powerful, well-trained sales force, a thorough knowledge of the market-demand situation, and flexible sales and production policies.

Because of lack of space, the author shall discuss only one more cause, which although only of a contributory nature, frequently accelerates the over-all deterioration process.

Inadequate Accounting Methods and Records

It is a well-known fact that smaller firms especially are likely to have lax or inadequate methods of accounting. Many owners of such small businesses are of the opinion that they cannot afford an accounting system, however elementary. Some do not wish to be bothered to keep a set of books and are convinced that their daily personal contact with the business obviates the need for accounting records.

After discussing the various causes of business failures, it seems quite obvious that adequate accounting records are an essential prerequisite for any type of intelligent and sound business decisions, and that a manager without such adequate quantitative data is much like the captain of a boat without a compass to guide him to his desired destination.

Tools for Diagnosis and Prevention of Business Failures

Since most of the before-discussed causes of business failures find their reflection in the financial statements, it is only logical to start investigations as to a company's degree of solvency, profitability and stability with a careful analysis of the financial statements.

Ratios and Percentages

The analytical measures obtained through comparison of individual statement items to each other and with corresponding ones on earlier statements, usually expressed as ratios and percentages, provide a fairly good basis for evaluating a company's ability to meet its debts as they come due, its success in earning an adequate return on its assets, and its degree of stability. Ratios and percentages become especially meaningful when compared with corresponding ones of other companies in the same or similar industry, and with industry averages.

The most commonly used ratio to indicate the degree of financial strength is the current ratio. Its purpose is to portray, by relating current assets to current liabilities, the enterprise's ability to meet current obligations. This ratio, however, does not take into account the distribution of the various items making up the current assets, and the length of time it may take to convert them into cash required to liquidate the current liabilities.

To truly test a company's solvency, another more severe test is in frequent use, the liquidity ratio or the "acid test" ratio. This ratio, by including only strictly liquid assets (cash, receivables and marketable securities) in current

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assets and comparing their total with current liabilities, measures the "instant" debt-paying ability of a company. When compared with ratios for previous periods and those of other firms in the industry, the acid-test ratio is a fairly dependable indicator of a company's relative solvency.

In order to test the efficiency in asset utilization, and whether over-investment exists in any one area, various turn-over ratios are computed.

To gauge the level of investment in fixed assets, a fixed asset turn-over ratio is used, which expresses the relationship of the investment in fixed assets and the sales volume. If this ratio is below the industry average, it indicates inefficiency in utilizing fixed assets to create sales, or obvious over-investment in this area. In such cases, management will have to take corrective steps, either by attempts to increase the production and sales volume, or by selling some of the excess to free the frozen funds for profitable use.

Since excessive inventories also tie up valuable working capital, various inventory turnover ratios are computed which express the frequency with which the average level of inventory investment is "recouped" or "turned-over" through operations. The higher the turnover is, the better the performance, since maagement was able to operate with a relatively small commitment of funds. To judge the reasonableness of inventory turn-over of a specific firm, comparison of the ratio with previous periods and with corresponding industry data is a must. Any indication of over-investment requires immediate remedial action through acceleration in sales efforts or temporary reduction in production.

To test the managerial efficiency of the credit and collection departments, as well as the quality and size of accounts receivable, turnover ratios or ratios indicating the number of average day's sales outstanding at a certain date are in use. If these ratios indicate a collection period in excess of the credit term, immediate action is desirable to free those unprofitable funds and return them to income-producing use.

Other ratios explore the soundness of the relationship between all borrowed funds and equity capital by appraising the company's ability "to weather times of stress" and to meet both its short-term and long-term obligations. These so-called equity ratios also supply insight into the relative size of the "cushion" of ownership funds creditors can rely upon to absorb possible losses from operations, decreases in asset values and poor estimates of future fund flows."[3] Although seemingly prudent, a very large cushion is not always the best policy to pursue, especially when a firm's operations and industry have such risk characteristics that it would be advantageous to make more extended use of low-cost debt to maximize profits. The most reasonable debt-equity ratio is one that will permit the business to make reasonable use of borrowed funds and still face the future without fear of insolvency.

To appraise the adequacy of sales and resulting profits, profitability ratios are in use which relate the net return to total assets, net assets, or net worth. By relating profits to sales volume and the cost of goods sold, certain ratios help in appraising the efficiency of operations. Some test the cost-profit-volume relationship by exploring the relationship of profit margins, assets turn-over and sales volume.

Besides ratios, other tools of financial analysis, useful in the prevention of possible business failures, have been developed over the past decades.

Preventive Tools

Since maintenance of financial soundness requires continuous decisions as to the best uses and best sources of funds, it is obvious that management has to be informed periodically as to the impact and quality of their past decisions in this respect.

Periodic fund-flow and cash-flow statements, through meaningful arrangement of the in-flows and out-flows of funds and cash, create in management an awareness of the vital importance of these decisions and enable it to judge whether past decisions resulted in normal fund and cash movements, or if they were abnormal and invite closer scrutiny.

To improve the quality of future managerial decisions, it is desirable to prepare annually break-even and gross profit studies, which will make management conscious of the company's specific profit-volume-and-cost relationship.

The best preventive measure, however, is a well-constructed accounting system, suitable not only for conventional score-keeping, but also for control, attention-directing and problem-solving. Such a system will enable management to react rationally to the various vital issues confronting it, and will keep it informed as to the development of possible weaknesses and conditions which might lead to business failure.

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[3]Erich A. Helfert, "Techniques of Financial Analysis", Richard D. Irwin, Inc., Homewood, Illinois.

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Conclusion

After having studied the most obvious causes of business failures, one feels justified to conclude that the majority of business casualties is caused by lack of knowledge and partial or total inexperience of management.

Throughout our study we found obvious similarities between an ailing business and a human being suffering from various diseases. Some of the causes of business failure were even comparable with human ailments. Over-investment in various assets slows down their turn-over, impairs the working capital position and adversely affects the over-all profitability, just as over-weight of a human being strains unduly various organs and impairs the over-all well-being of the individual. Lack of working capital and cash may slowly paralyze operations, just as a condition of anemia in a human creates listlessness and growing loss of energy.

Most ailments of a business, just like those of a human being, are fairly easily curable when detected at an early stage, while when permitted to grow, only drastic measures, such as a complete reorganization or an operation might prevent the final tragedy.

Periodic check-ups by professional authorities, such as accountants or business analysts, are therefore a vital necessity. And just like with people, where preventive measures are the best medicine, business management also should take advantage of the various preventive control tools developed over the past decades for assisting and enabling him in creating and maintaining a sound, healthy and growing enterprise.

The fact that failure or success of a business depends primarily on the knowledge and skill of management and its effective use on quantitative data as supplied by accounting is just as true today as it was centuries ago when a London Merchant asked the following crucial question:

> "Is it not as impossible that a merchant should be prosperous in trade without being a thorough-pac'd accountant, and having all other accomplishments suitable to the nature of his great employ, as that a mariner should conduct a ship to all parts of the globe without a skill in navigation?"[4]
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> —A Merchant of London (Ca 1700)

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[4] "The World of Business" Volume 1, p. 60, Harvard Business School.

TIPS FOR BUSY READERS

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"We Control Costs at Their Source," Art P. Jarrett, *National Association of Accountants Management Accounting,* February 1966, Volume XLVII Number 6.

Since one of the effective ways to increase profits is to control costs, this article should be of interest to all manufacturing companies. Also, some of the ideas presented might be applied in businessess not engaged in manufacturing. Basically the plan for controlling costs in the Anderson Electric Corporation, Leeds, Alabama, involves recognizing the importance of communication with "line" supervision and making use of an operational format which encompasses profit plan guidelines founded upon communication and togetherness. The company has adopted a system of evaluation and communication which measures labor efficiency, regulates personnel employment, and controls expenditures of the manufacturing division. The foremen help to prepare the company's flexible budget and then receive weekly status reports in terms understandable to them. The company also uses monthly sales forecasts, production and inventory control procedures, and budgets developed for cost centers.

An unusual feature of the system is that after the monthly production format has been accepted, and after support and responsibility have been established for its execution, the financial guidelines become manufacturing control values. Expense vouchers and obligatory requisitions are the foremen's responsibility. An obligation procedure is used for all manufacturing values requiring a purchase commitment. Ledger cards show at all times charges depleting, or adjustments realigning, the unobligated cost and expense values of the current month. Manufacturing control values are posted to expense ledger cards for each manufacturing department at the beginning of the month, and supply and expense requisitions received from the foremen are posted during the month to reduce the budgeted amount. The unencumbered account balance remaining is indicated upon each requisition prior to scrutiny and confirmation by the operations manager. Nonapproved requisitions are returned immediately to originators for a personal request or additional information relative to their urgency. The purchasing department processes only those requisitions which come within the budget and are approved by the operations manager. Trial balances of unobligated account values are prepared weekly and over-expenditures are explained at weekly plant staff meetings.